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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1935

No. 774

CORINNE S. KOSHLAND,
Petitioner,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR PETITIONER.

JOHN C. ALTMAN,
Russ Building, San Francisco, California,
Attorney for Petitioner.

WILLARD L. ELLIS,
Russ Building, San Francisco, California,
Of Counsel.

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OPINIONS BELOW.

The opinion of the Board of Tax Appeals (R. 25-32) is an unpublished Memorandum Opinion. The opinion of the Circuit Court of Appeals (R. 108-133) is reported in 81 Fed. (2d) 641.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered January 20, 1936. (R. 134.) Petition for certiorari was filed February 25, 1936, and was granted March 30, 1936. The jurisdiction of this Court rests upon Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Where a dividend is declared upon cumulative non-voting preferred shares, payable in common voting shares, may the original cost of the preferred shares be reduced by apportioning such cost between the preferred and common shares for the purpose of determining gain or loss under the Revenue Act upon the sale or other disposition of the preferred shares?

STATUTES AND REGULATIONS INVOLVED.

The pertinent statutes and regulations involved will be found in the Appendix, *infra*.

STATEMENT.

The undisputed facts may be summarized as follows:

Petitioner acquired by purchase in 1924 and 1926 certain shares of preferred stock of Columbia Steel Corporation. (R. 26, 27, 42.) The Articles of Incorporation of Columbia Steel Corporation provided that

the holders of its preferred stock should receive annually as dividends thereon $7.00 per share in cash or, at the option of the corporation, one share of its common stock for each share of preferred stock. The Articles further provided that dividends on the preferred stock should be paid in full before any dividend should be paid or payable on the common stock. All voting rights pertained to the common stock, none to the preferred. (R. 26, 89.) The preferred stock was redeemable by the corporation at the sum of $105.00 per share, plus all accrued dividends. Upon any dissolution or liquidation of the company, the preferred stock was entitled to a preferential payment of $100.00 per share, plus all accrued dividends, and no more. The common stock was solely entitled, upon dissolution or liquidation, to all the residual assets of the corporation then remaining. (R. 89.)

In each of the years, 1925, 1926, 1927 and 1928, the corporation had a surplus sufficient to pay the preferred dividends in cash, but exercised its election to pay them in common stock, as authorized by its Articles. Petitioner received in those years shares of common stock as dividends on her preferred stock. In 1930 the corporation redeemed its preferred stock at $105.00 per share. (R. 26, 27, 59.) In computing the profit realized by petitioner, the Commissioner allocated to the common stock received, in each instance, a proportionate amount of the cost of the preferred stock upon which it was paid. This action of the Commissioner decreased the cost basis to petitioner of the preferred stock and increased the profit resulting from its redemption. (R. 28.)

The Board of Tax Appeals disapproved the Commissioner's determination and held that the dividends received in common stock did not constitute stock dividends representing the mere dilution of the stockholders' present interests but were taxable dividends which did not serve to reduce the cost basis of the preferred stock upon which they were paid. (R. 30-31.)

The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals and approved the Commissioner's determination. (R. 134.)

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

1. In holding that a dividend declared upon cumulative non-voting preferred shares, payable in common voting shares, constituted a non-taxable stock dividend.

2. In holding that, for income tax purposes, dividends in the form of common stock paid upon preferred stock, whether income or not, should be treated as merely constituting additional evidence of the preferred stockholder's capital investment and that, for the purpose of determining gain or loss on the disposition of the preferred shares, the original cost of the preferred shares should be apportioned between the preferred stock and the common stock received as dividends thereon, in proportion to their respective values.

3. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT.

I.

The test to be applied in determining whether a dividend paid by a corporation in the form of its own stock is or is not income, is whether, after the distribution, the stockholders have the same proportional interest of the same kind as they formerly possessed. If the dividend amounts to a mere splitting of the certificates formerly held by each stockholder into a greater number of smaller units, the stockholder receives no income through the dividend. If, on the other hand, the stock received as a dividend is entirely different in character from that originally held and, when added to the stockholder's original holding, creates an interest in the corporation entirely different from and in addition to that of his original holding, income results from the receipt of the dividend. The dividend in the form of comon voting shares which petitioner received upon her cumulative non-voting preferred stock resulted in an increase in her interest in the corporation. Consequently, such dividend constituted income to her at time of receipt.

II.

A. The Revenue Acts in effect at the times when petitioner received the dividends in the form of shares of common stock provided that: "A stock dividend shall not be subject to tax". Congress, in so exempting stock dividends from tax was referring only to such dividends as did not constitute income. It did not exempt dividends of the type received by petitioner.

B. Even assuming that Congress exempted from taxation dividends of the type received by petitioner, it does not follow that, for the purpose of determining gain or loss upon the subsequent disposition of petitioner's preferred shares, the cost thereof should be reduced by reason of the prior receipt of the dividend in common shares. The mere exemption from taxation by Congress of an otherwise taxable dividend cannot, upon a subsequent sale, affect the cost basis of the shares of stock in respect of which the dividend was paid, unless Congress shall have made appropriate provision for the adjustment of such cost basis. Since no such appropriate provision appears in the applicable Revenue Act, it was improper to reduce the cost of petitioner's preferred stock by assigning a portion thereof to the common stock received as a dividend thereon.

ARGUMENT.

PRELIMINARY STATEMENT.

The Commissioner, in computing the profit realized by petitioner on the disposition of shares of cumulative non-voting preferred stock, apportioned the cost thereof between those shares and shares of common voting stock received as dividends thereon. If the receipt of the common voting shares did not constitute income to petitioner, it is conceded that the action of the Commissioner was correct. On the other hand, if, as petitioner contends, the receipt of the common stock did constitute income to her, then the adjustment by

the Commissioner of the cost of the preferred stock was improper, regardless of whether or not Congress exempted the dividends from taxation at time of receipt. This conclusion follows, because "cost" is the only basis prescribed in the Revenue Act for determining the gain to petitioner on the disposition of her preferred stock, and no provision is contained in the Act authorizing the Commissioner to deduct, from the cost of such stock, the income produced therefrom.

I.

THE DIVIDENDS IN THE FORM OF COMMON STOCK CONSTITUTED INCOME TO PETITIONER WHEN RECEIVED.

In order to determine whether the dividends declared by Columbia Steel Corporation upon its cumulative non-voting preferred shares, payable in its common voting shares, constituted income to the preferred shareholders, it is essential that certain facts with respect to the capital structure of the corporation be kept in mind. At all material times, Columbia Steel Corporation had outstanding shares of preferred stock of a par value of $100.00 per share and shares of common stock, without par value. The preferred shares of the corporation were entitled to cumulative preferential dividends at the rate of 7% per annum, which, under the charter of the corporation, could be and were paid during the first five years of the existence of the company, in common stock of the corporation, at the rate of one share of common stock per annum for each share of preferred stock outstand-

ing. The preferred stock had no voting rights, all voting rights being vested in the shares of common stock. The preferred stock was redeemable by the corporation at the sum of $105.00 per share, plus all accrued dividends. Upon any dissolution or liquidation of the company, the preferred stockholders were entitled to a preferential payment of $100.00 per share, plus all accrued dividends, after which the preferred stockholders had no further participation in any residual assets of the corporation.

In *Eisner v. Macomber,* 252 U. S. 189, this Court was called upon to consider whether a 50% dividend declared by a corporation upon its stock, payable in the form of additional shares of precisely the same character, constituted income to the recipient. The Collector of Internal Revenue assessed an income tax against Macomber on that part of the value of the stock dividend which represented surplus earned by the corporation between March 1, 1913, and the date of the payment of the dividend. As the basis of his exaction, the Collector relied upon Section (2) (a) of the Revenue Act of 1916, 39 Stat. 757, which provided that a "stock dividend shall be considered income, to the amount of its cash value". Macomber contended that the stock dividend which she received did not constitute income to her and that consequently Congress had no power under the Sixteenth Amendment to impose a tax upon her by reason of the receipt of such dividend. This Court sustained the contention of Macomber, stating at page 219 that:

> "The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such

dividend, contravenes the provisions of Article 1, §2, cl. 3, and Article 1, §9, cl. 4, of the Constitution and to this extent is invalid notwithstanding the 16th Amendment."

In arriving at the conclusion that the dividend in question did not constitute income to the taxpayer, this Court was apparently influenced by two factors, namely: (1) there was no severance of the corporate assets, and hence no income received by the distributee and (2) the dividend did not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or the aggregate holdings of the other stockholders as they stood before.

It is difficult to determine from a reading of *Eisner v. Macomber* alone, which point this Court regarded as vital. Any uncertainty, however, as to the true basis for the decision in *Eisner v. Macomber* has been effectually dispelled by the later decision of this Court in *Marr v. United States*, 268 U. S. 536. The facts in that case were as follows: The taxpayer had purchased certain shares of 7% preferred stock and certain shares of common stock in General Motors Company of New Jersey. The voting privileges attached to both classes of shares. Subsequently, the corporation having accumulated a large surplus, a new corporation was formed under the laws of Delaware known as General Motors Corporation of Delaware, which offered to issue to stockholders of the New Jersey corporation five shares of its common stock for each share of common stock of the New Jersey corporation, and 1½ shares of its 6% non-voting preferred stock for each share of preferred stock of the

New Jersey corporation. All of the common stock of the New Jersey corporation was exchanged on this basis as was all but a few shares of preferred, which were redeemed in cash. Having become the owner of all of the stock of the New Jersey corporation, the Delaware corporation caused the assets of the New Jersey corporation to be transferred to it, subject to the liabilities of the transferor corporation. Thereupon the New Jersey corporation was dissolved. The taxpayer exchanged all of his stock in the manner outlined.

The Government contended that the difference between the cost of the stock of the New Jersey corporation and the value of the stock in the Delaware corporation which the taxpayer received in exchange, constituted taxable income to him. The taxpayer on the other hand, contended that such difference could not constitutionally be taxed under the rule of *Eisner v. Macomber,* supra.

This Court, in sustaining the contention of the Government, stated, at page 539:

> "Marr contends that, since the new corporation was organized to take over the assets and continue the business of the old, and his capital remained invested in the same business enterprise, the additional securities distributed were in legal effect a stock dividend; and that, under the rule of Eisner v. Macomber, 252 U. S. 189, 64 L. ed. 521, 9 A. L. R. 1570, 40 Sup. Ct. Rep. 189; applied in Weiss v. Stearn, 265 U. S. 242, 68 L. ed. 1001, 33 A. L. R. 520, 44 Sup. Ct. Rep. 490, he was not taxable thereon as income, because he still held the whole investment. The

government insists that identity of the business enterprise is not conclusive; that gain in value resulting from profits is taxable as income, not only when it is represented by an interest in a different business enterprise or property, but also when it is represented by an essentially different interest in the same business enterprise or property; that, in the case at bar, the gain actually made is represented by securities with essentially different characteristics in an essentially different corporation; and that, consequently, the additional value of the new securities, although they are still held by the Marrs, is income under the rule applied in United States v. Phellis, 257 U. S. 156, 66 L. ed. 180, 42 Sup. Ct. Rep. 63; Rockefeller v. United States, 257 U. S. 176, 66 L. ed. 186, 42 Sup. Ct. Rep. 68; and Cullinan v. Walker, 262 U. S. 134, 67 L. ed. 906, 43 Sup. Ct. Rep. 495. In our opinion the government is right.

In each of the five cases named, as in the case at bar, the business enterprise actually conducted remained exactly the same. In United States v. Phellis, in Rockefeller v. United States, and in Cullinan v. Walker, where the additional value in new securities distributed was held to be taxable as income, there had been changes of corporate identity. That is, the corporate property, or a part thereof, was no longer held and operated by the same corporation; and, after the distribution, the stockholders no longer owned merely the same proportional interest of the same character in the same corporation. In Eisner v. Macomber, and in Weiss v. Stearn, where the additional value in new securities was held not to be taxable, the identity was deemed to

have been preserved. In Eisner v. Macomber the identity was literally maintained. There was no new corporate entity. The same interest in the same corporation was represented after the distribution by more shares of precisely the same character. It was as if the par value of the stock had been reduced, and three shares of reduced par value stock had been issued in place of every two old shares. That is, there was an exchange of certificates, but not of interests. In Weiss v. Stearn, a new corporation had, in fact, been organized to take over the assets and business of the old. Technically there was a new entity; but the corporate identity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same state, with presumably the same powers as the old. There was also no change in the character of securities issued. By reason of these facts, the proportional interest of the stockholder after the distribution of the new securities was deemed to be exactly the same as if the par value of the stock in the old corporation had been reduced, and five shares of reduced par value stock had been issued in place of every two shares of the old stock. Thus, in Weiss v. Stearn, as in Eisner v. Macomber, the transaction was considered, in essence, an exchange of certificates representing the same interest, not an exchange of interests.

In the case at bar, the new corporation is essentially different from the old. A corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey. Because of these inherent differences in rights and powers,

both the preferred and the common stock of the old corporation is an essentially different thing from stock of the same general kind in the new. But there are also adventitious differences, substantial in character. A 6 per cent, non-voting, preferred stock is an essentially different thing from a 7 per cent, voting, preferred stock. A common stock subject to the priority of $20,000,000.00 preferred and a $1,200,000.00 annual dividend charge is an essentially different thing from a common stock subject only to $15,000,000.00 preferred and a $1,050,000.00 annual dividend charge. The case at bar is not one in which, after the distribution, the stockholders have the same proportional interest of the same kind in essentially the same corporation."

It is significant that this Court, in *Marr v. United States* regarded *Eisner v. Macomber,* supra, as controlling, and considered the exchange of securities by the taxpayer in legal effect the same as a dividend. It is also significant that this Court in *Marr v. United States* recognized, as was pointed out in the dissenting opinion in that case, that "the stockholder received nothing actually severed from his original capital interest." The sole basis therefore for the decision that the additional value of the new securities received by the taxpayer constituted income, was that the stockholders after the distribution did not "have the same proportional interest of the same kind in essentially the same corporation."

It is clear, therefore, that the true test, as laid down by this Court in *Eisner v. Macomber* and clarified by *Marr v. United States,* to be applied in de-

termining whether a dividend in the form of stock is or is not income, is not whether the taxpayer receives assets which have been severed from the corporation, but whether after the distribution, the stockholders have the same proportional interest of the same kind as they formerly possessed. If the dividend distributed to stockholders in the form of additional shares of stock amounts to a mere splitting of the certificates formerly held by each stockholder into a greater number of smaller units, so that the old and new shares aggregate a stock interest in the company substantially the same as he held before the dividend, the stockholder receives no income through the dividend. If, on the other hand, the stock received as a dividend is entirely different in character from the stock originally held by the stockholder, and when added to the stockholder's original holding, creates an interest in the corporation entirely different from and in addition to that of his original holding, income results from the receipt of the dividend.

In *Commissioner of Internal Revenue v. Tillotson Manufacturing Company*, 76 Fed. (2d) 189, the Circuit Court of Appeals for the Sixth Circuit, held that a dividend of the same character as that involved in the case at bar, namely, a dividend on cumulative non-voting preferred shares, payable in common voting shares of the same corporation, was income to the recipient. The Court in that case analyzed the decision of this Court in *Eisner v. Macomber*, supra, and stated:

"The Commissioner urges that under the decisions of the Supreme Court of the United States, and particularly Eisner, Collector, v. Macomber, 252 U. S. 189, this particular distribution of common stock is not subject to tax, and that the Board of Tax Appeals erred in its order and decision. In that case, common stock was distributed pro rata to common stockholders. The decision that the dividend was not subject to tax was based partly upon the proposition that there was no severance of the corporate assets, and hence no income received by the distributee. However, it was also pointed out in that case, as a material fact, that the dividend did not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before.

Two tests were thus established for distinguishing a taxable from a non-taxable dividend in stock: (1) Severance of assets from the corporation, and (2) alteration of the pre-existing proportionate interest of the stockholders.

In the instant case the first test was met. There was no severance of corporate assets. The distribution was made to its preferred shareholders by the corporation, not in stock of another corporation, not from its own treasury stock, but from its own unissued stock.

The second test was not met. The pre-existing proportionate interest of the stockholders was substantially altered.

* * * * * * *

United States v. Phellis, 257 U. S. 156, presented the case of a reorganization resulting in

the formation of a company not substantially identical with the first. The court, holding that a dividend in stock of the old company paid in stock of the new company was taxable as individual income, stressed the fact that the individual stockholders of the old company 'received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit'.

The court also stated that the liability of a stockholder to pay an individual income tax must be decided by the effect of the transaction upon the individual.

Weiss, Collector, v. Stearn, 265 U. S. 242, held that a dividend in stock was non-taxable upon the ground that it constituted an issuance and exchange of certificates representing the same pre-existing interest. The court again declared that to constitute gain 'separated from the original capital interest', the stockholder must receive 'a thing really different from what he theretofore had'.

In Marr v. United States, 268 U. S. 536, the distribution of stock was held to constitute taxable income. The court grounded its decision upon the fact that after the distribution the stockholders no longer owned 'the same proportional interest of the same kind in essentially the same corporation'.

It is true that there is a distinction between the instant case and those cited. Here the dividend issued to the preferred stockholders in

payment of the accrued preferred dividends was unissued stock of the corporation itself, not stock in any other corporation. However, the right to share in assets upon dissolution, and in the earnings of the corporation upon the declaration of dividends, was materially altered. Each preferred stockholder, in consideration of relinquishing his rights to the accrued preferred dividends, secured new voting rights, and additional property rights which might well afford him a different and greater market with an increased money return. In fact the precise situation was presented, described under different circumstances, in United States v. Phellis, supra, that the preferred stockholders received assets of an exchangeable and actual value proceeding from their capital interest in the old company, drawn by them for their individual and separate use and benefit.

We think that the mere circumstance that this transformation was effected within one single organization does not alter the applicability of these rules. The Commissioner erred in applying to the transaction one test only of those laid down in Eisner, Collector, v. Macomber, supra, and the other decisions above cited. Applying the other test, namely, that of alteration of proportionate interests, the preferred stockholders received taxable income, and respondent did not err in the computation of its taxable gain.

The decision of the Board of Tax Appeals is affirmed."

The majority opinion in the Court below gave no consideration to the question whether the dividends

received by petitioner were or were not in fact income, holding that:

> "The question here is not what Congress could tax, but what it has taxed * * * Whether such dividends constitute income it is unnecessary to decide. If they are not income, they are exempt from taxation under the Sixteenth Amendment. If they are income, they are still exempt by the express provisions of these Acts. * * * Assuming, without deciding, that Congress might constitutionally have taxed stock dividends of this type, we hold that it was within the power of Congress to exempt such dividends from taxation and to treat them as other stock dividends are treated. * * * such dividends, whether income or not, should be treated as merely constituting additional evidence of the stockholder's capital investment."
>
> (R. 112-114.)

The dissenting opinion in the instant case held that the dividends received by petitioner definitely constituted income, stating:

> "The fundamental question here is whether or not certain language of Eisner v. Macomber, suggesting that no stock dividend could be income because it detached nothing from the corpus of the company's property, must be projected beyond the facts presented in that case. Must it be deemed to apply to dividends of stock not identical with the stock on which the dividend is declared and which, under no theory, could be regarded as a mere splitting of stock certificates, leaving the stockholder with a personal prop-

erty, identical in its value and character, with what he had before the dividend? * * *

The ratio decidendi of Eisner v. Macomber, in my opinion, is expressed in the following excerpts from the opinion:

'The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same *proportional interest* that the original shares represented before the issue of the new ones. * * * What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new.

* * * * * * *

It does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.'

* * * * * * *

This interpretation of Eisner v. Macomber is sustained by the subsequent decision of the Supreme Court. In Weiss v. Stearn, 265 U. S. 242, the assets of the corporation were transferred to a new corporation and thereupon identical stock interests in the assets were created and the stock issued to the stockholders of the first corporation. The result of the transaction was that each stockholder had the same proportionate interest or expectancy in the corporate assets as he had before the transfer. The Supreme Court held that the

transfer of the assets to a new corporation and the stock dividend declared by the new entity placed the stockholder in no different position than if a dividend of identical stock had come from the old corporation. There was no income to the holder of the new shares from the second corporation within the meaning of the Sixteenth Amendment.

In Marr v. U. S., 268 U. S. 536, 540, 541, 542, the assets were transferred to a new corporation of another state whose laws made the stock issued to the old stockholders of a different character from that held in the first corporation. This stock, because of its difference in character, was held to be income and the tax thereon was sustained by the decision. The difference between the Weiss case and the Marr case is not that the new corporation in the one case was incorporated in the same state and the other in a different state. If the second charter in the Marr case had been so drawn that the stock distributed had given the distributee identical voting power and capital expectancy, the decision would have been the same in the latter case as in the Weiss case.

* * * * * * *

The essence of the distinction between the Weiss and Marr cases is that in the latter the stockholder as a result of the stock dividend gets something more than a mere 'exchange of certificates but not of interest'. The stock is taxable because 'both the preferred and common stock of the old corporation is an essentially different thing from the stock of the same general kind in the new'. That is to say, with reference to the case at bar, the common stock with voting rights is something

essentially different and new both as to capital expectancy and voting power from the preferred stock without voting rights."

(R. 125-132.)

If, as we believe is established by the decisions of this Court, a dividend paid in the form of stock of the issuing corporation is income to the recipient whenever, through the dividend, the pre-existing proportionate interests of the stockholders are substantially altered, it is apparent that the dividend paid on the preferred shares in the form of common shares of Columbia Steel Corporation constituted income to the preferred stockholders. Before the dividend declared by Columbia Steel Corporation, the preferred stockholders had solely a limited participation in the assets, which was fixed in amount and extent. All that the preferred stockholders were entitled to receive by virtue of their holdings was (a) preferential payment of cumulative dividends in a specified amount, and (b) a preferential right to receive $100.00 per share, plus accrued dividends, and no more, upon dissolution or liquidation, any residual value of the assets being distributable ratably to the common stockholders, or (c) payment of $105.00 per share, plus accrued dividends in case of redemption. When petitioner received the shares of common stock as a dividend upon the preferred shares, her former interest was increased, because petitioner and all other preferred stockholders owned additionally a proportional interest in the residual assets of Columbia Steel Corporation remaining over and above the preferential pay-

ment to the preferred stockholders. The common stock thus received could have been sold, and after any such sale the preferred stockholders would, aside from the proceeds of sale, still have maintained their identical original financial position in the corporation. Manifestly, this situation is far different from that where a common stockholder receives, by way of a stock dividend, additional shares of common stock, as a result of which his proportional interest in the corporate property still remains identical, and he has two pieces of paper in lieu of one, but with no greater interest in the corporate assets.

It thus follows that the dividends received by petitioner in the form of common stock constituted income to her which Congress could have taxed under the authority vested in it by the Sixteenth Amendment to the Constitution.

II.

SINCE THE DIVIDENDS IN THE FORM OF COMMON STOCK CONSTITUTED INCOME TO PETITIONER WHEN RECEIVED, THEY CANNOT PROPERLY BE TREATED AS REDUCING THE COST TO PETITIONER OF HER PREFERRED STOCK.

(A) Congress Did Not Exempt Such Dividends From Taxation When Received.

Congress in the Revenue Acts of 1916, 1917 and 1918 attempted to tax stock dividends as income by providing that "a stock dividend shall be considered income, to the extent of its cash value". Such attempt was held to be unconstitutional in *Eisner v. Macomber*, supra (decided in 1920), because, as heretofore pointed out, a dividend in stock which in no way changes the

proportional interests of the shareholders is not income.

In the Revenue Act of 1921, after the decision in *Eisner v. Macomber,* Congress excluded stock dividends from taxation in Section 201(d) of that Act,[1] providing:

> "A stock dividend shall not be subject to tax."
> (42 Stat. 228.)

Petitioner contends that the dividends in the form of common stock of Columbia Steel Corporation which she received upon her preferred stock were not "stock dividends" within the meaning of the above-quoted provisions of the Revenue Acts.

The term "stock dividend" was first defined and limited by this Court in *Gibbons v. Mahon,* 136 U. S. 549, the Court stating at page 559:

> "A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares, and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones."

1. Section 201(f) of the 1926 Act and Section 115(f) of the 1928 Act are exact counterparts of Section 201(d) of the 1921 Act.

While no question of taxation was involved in *Gibbons v. Mahon*, the foregoing definition of a stock dividend has subsequently received the approval of this Court in *Eisner v. Macomber*, supra, and other tax cases.

The reason for the enactment of Section 201(d) of the 1921 Act is to be found in House Report No. 350, 67th Congress, 1st Session, page 8:

> "Section 202 modifies the definition of dividends in existing law by exempting stock dividends from the income tax, as required by the decision of the Supreme Court in Eisner v. Macomber. (252 U. S. 189.)"

Similar language is contained in Senate Report No. 275, 67th Congress, 1st Session, page 9. It is therefore an established fact that Congress in the Revenue Act of 1921 was exempting "stock dividends" from taxation solely because such action was "required by the decision of the Supreme Court in Eisner v. Macomber". This being so, it seems apparent that Congress was exempting only the type of dividends which possessed the characteristics referred to in *Gibbons v. Mahon* and *Eisner v. Macomber*.

As aptly stated by the Board of Tax Appeals in *Tillotson Manufacturing Co. v. Commissioner*, 27 B. T. A. 913, 918:

> "When it is realized that the occasion for the original prototype of Section 201(f), namely, Section 201(d) of the Revenue Act of 1921, exempting stock dividends from tax, was the decision of the Supreme Court in Eisner v. Macomber, supra, annulling so much of Section

> 2(a) of the Revenue Act of 1916 as included stock dividends among those taxable, it becomes clear that the subsequent statutory exemption was only as broad as the decision, and hence that the intention was not to exempt stock dividends by any general or loose concept, but only such as could not constitutionally be taxed because they were not income. The term 'stock dividend' is not of itself so free from ambiguity as to preclude construction, and hence the statutory exemption must be construed to promote the intendment disclosed by the history and circumstances of its enactment. This requires that it be confined to such as have the attributes which distinguished them from the receipt of income by the shareholder. Only those which place the shareholder in no essentially different position are exempt."

We fully realize that definitions may be found in dictionaries and textbooks to the effect that a "stock dividend" is "a distribution of the stock of the corporation among the stockholders as a dividend". (*Thompson on Corporations,* 3d ed. Vol. 7, page 137, Sec. 5263.) Under such a definition any distribution by a corporation to its stockholders of its own stock could be regarded as "a stock dividend". However, the definition of the term which Congress had in mind when it drafted the Revenue Act of 1921 was not any loose general definition, but rather the definition of the term as first stated by this Court in *Gibbons v. Mahon,* supra, and approved in *Eisner v. Macomber.*

The statutory provision with respect to stock dividends creates an exemption from taxation. Any construction therefore which would extend such exemp-

tion to transactions not clearly within the contemplation of the statutory provision should be rejected. (*Bank of Commerce v. Tennessee,* 161 U. S. 134, 146.)

(B) Assuming That Congress Exempted Such Dividends From Taxation When Received, no Authority Exists in the Revenue Act for Reducing the Cost of the Preferred Stock by Assigning Any Portion of its Original Cost to the Common Stock.

If, as we contend, Congress did not exempt from taxation dividends paid on preferred stock in the form of common stock, it necessarily follows that the judgment of the Court below must be reversed. The majority opinion concedes that if our premise be correct, the conclusion drawn follows as a matter of course. (R. 110.)

However, even if we assume that Congress did exempt from taxation, at the time of receipt, dividends of the character here involved, it by no means follows that, for the purpose of determining gain or loss under the Revenue Act upon the disposition of the preferred shares, the original cost of the preferred shares may be reduced by apportioning such cost between the preferred and common shares.

The redemption of the preferred stock held by petitioner occurred in the year 1930. The determination of gain or loss to petitioner upon such redemption is therefore governed by the Revenue Act of 1928. Section 111(a) of that Act provides:

> "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in Section 113 * * *."
>
> (45 Stat. 815.)

Section 113 provides that:

> "The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that * * *."[2]
>
> (45 Stat. 818.)

As pointed out by the Court of Appeals of the District of Columbia in respect of the exceptions to the ordinary rule of cost prescribed by Section 204 of the Revenue Act of 1926, 44 Stat. 14 (Section 204 of the 1926 Act being a counterpart of Section 113 of the Revenue Act of 1928):

> "The purpose of these provisions was to make applicable an exception to the ordinary basis for determining gain or loss, i. e., cost to taxpayer * * *."
>
> *Elmore Milling Co. v. Helvering*, 70 Fed. (2d) 736.

None of the exceptions can possibly have any application to the instant case. We thus have a situation where petitioner has disposed of certain shares of preferred stock owned by her and where

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2. The exceptions are twelve in number, contained in separate subdivisions of Section 113, and have reference to:
Property which should have been included in the last inventory. (Subdiv. 1.)
Property acquired by gift or transfer in trust after December 31, 1920. (Subdivs. 2 and 3.)
Property acquired by a gift or transfer in trust before January 1, 1921. (Subdiv. 4.)
Property transmitted at death. (Subdiv. 5.)
Property acquired in connection with specified statutory tax-free exchanges of property. (Subdiv. 6.)
Property acquired by a corporation in connection with a reorganization where the control remains in specified persons. (Subdivs. 7 and 8.)
Securities received by way of distribution upon reorganization without the surrender of the original securities held. (Subdiv. 9.)
Property acquired as a result of a compulsory or involuntary conversion. (Subdiv. 10.)
Stock or securities acquired by "wash sales". (Subdiv. 11.)
Property acquired by a corporation during affiliation. (Subdiv. 12.)

the only statutory provision with respect to the method for determining her gain or loss upon such disposition requires that the basis for such determination "shall be the cost of such property".

Notwithstanding the absence of any statutory authority for adjusting the cost basis to petitioner of her shares of preferred stock, the Commissioner, for the purpose of determining the gain to petitioner upon the redemption of the shares of preferred stock, has apportioned the cost between the preferred and common stock in proportion to their respective values. As the sole support for his action in so apportioning cost, the Commissioner relies upon Article 628 of Regulations 74. Article 628, in so far as material, provides that the issuance of its own stock by a corporation as a dividend to its shareholders does not result in taxable income to such shareholders, but the amount of gain derived or loss sustained from the sale of the stock in respect of which the dividend is issued shall be determined as provided in Article 600.

Article 600 was promulgated solely to carry into effect the provisions of Section 113 (o) of the Revenue Act of 1928.[3] That article, in so far as material, provides that where a shareholder receives distribution of stock in connection with a transaction described in

3. Section 113 (9) provides that if a stockholder receives stock or securities which have been distributed to him in connection with a transaction described in Section 112 (g) of the same Act, and thereafter disposes of the stock in respect of which the distribution was made, the basis for determining the gain or loss from the disposition of such stock "shall be apportioned under rules and regulations prescribed by the Commissioner with the approval of the Secretary" between such stock and the stock distributed. The sole transaction described in Section 112 (g) is the distribution to a stockholder, in pursuance of a plan of reorganization, of stock or securities in the same corporation or another corporation a party to the reorganization, without the surrender of the stock upon which the distribution was made; and the Section provides that no gain to the distributee from the receipt of such stock or securities shall be recognized.

Section 112(g) of the Revenue Act of 1928, 45 Stat. 818, and thereafter sells the original shares upon which such distribution was received, the gain or loss on the shares sold should be computed by apportioning the cost of the shares originally held between those shares and the shares acquired by distribution, in proportion to the respective value of each stock.

In *Manhattan General Equipment Company v. Commissioner*, 80 L. ed. Adv. Ops. 380 (decided Feb. 3, 1936), this Court had under consideration Section 204(a) (9) of the Revenue Act of 1926, and amended Article 1599 of Regulations 69, which were respectively exact counterparts of Section 113 (9) of the Revenue Act of 1928 and Article 600 of Regulations 74. That case involved the determination of the amount of loss to the taxpayer on the disposition of shares of stock originally held upon which there had been a distribution of the type described in Section 112(g) of the Revenue Act of 1928. As originally promulgated, Article 1599 of Regulations 69 contained a proviso limiting the cost attributable to the shares received by way of distribution to the market value of such shares at date of receipt, but in all other respects Article 1599 of Regulations 69 was identical with Article 600 of Regulations 74. At a later date Article 1599 was amended by the Commissioner so as to delete therefrom the proviso just referred to. The taxpayer sold certain shares of stock between the date of the promulgation of the original Article and the amended Article. The sole question involved before this Court was whether the loss of taxpayer was to be determined in accordance with the original or amended regulation. This Court held that the loss must be

determined under the amended regulation, because the original regulation was not only unreasonable, but inconsistent with the statute authorizing the promulgation thereof. In the course of his opinion, Mr. Justice Sutherland stated, at page 382:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. Lynch v. Tilden Co., 265 U. S. 315, 320-322; Miller v. United States, 294 U. S. 435, 439-440, and cases cited. And not only must a regulation in order to be valid, be consistent with the statute, but it must be reasonable. International Ry. Co. v. Davidson, 257 U. S. 506, 514. The original regulation as applied to a situation like that under review is both inconsistent with the statute and unreasonable.
>
> The contention that the new regulation is retroactive is without merit. Since the original regulation could not be applied, the amended regulation in effect became the primary and controlling rule in respect of the situation presented. It pointed the way, for the first time, for correctly applying the antecedent statute to a situation which arose under the statute. See Titsworth v. Com'r of Int. Rev., 73 F. (2d) 385, 386. The statute defines the rights of the taxpayer and fixes a standard by which such rights are to be measured. The regulation constitutes only a step in the administrative process. It does not and could not, alter

> the statute. It is no more retroactive in its operation than is a judicial determination construing and applying a statute to a case in hand."

Similarly, in *Morrill v. Jones*, 106 U. S. 466, it was held:

> "The Secretary of the Treasury cannot, by his Regulations, alter or amend a Revenue Act."

It is thus established by the decision of this Court in the *Manhattan* case, supra, that Article 600 of Regulations 74 derives its validity solely by reason of the fact that it carries into effect the provisions of Section 113(9) of the Revenue Act of 1928. As heretofore indicated, Section 113(9) applies exclusively to the particular type of transaction described therein, viz., the receipt of stock or securities, by way of distribution, in connection with a plan of reorganization, without the surrender of the stock in respect of which the distribution was made. The instant dividend does not classify as a transaction within the purview of Section 113(9). There is no other provision of the Revenue Act of 1928 authorizing the Commissioner to make any apportionment of cost. If the Commissioner, where expressly authorized by statute to apportion cost in a particular designated transaction may not prescribe a manner and method of apportionment which is inconsistent with the statute granting such right, *a fortiori* the Commissioner may not make any apportionment in respect of an entirely different transaction, where the statute gives him no such authority.

It therefore follows that the Commissioner may not rely upon Article 628 of Regulation 74 in support of his apportionment of the cost of petitioner's preferred stock between that stock and the common stock.

Where a stockholder has received, as a dividend, stock of precisely the same character as his original stock so that no income has resulted from the receipt of the dividend, it is entirely proper upon the subsequent disposition of the original stock to apportion the cost thereof between the original stock and the dividend stock. No statutory authorization exists in any of the Revenue Acts for such apportionment nor is any needed, because the apportionment of the cost of the original stock is in no sense an artificial "adjustment" of cost. In such case, the cost per share of the original stock is obviously not the quotient of the purchase price divided by the total number of shares originally purchased. "The old shares have proliferated, as it were, and although the right they represented has now suffered a cellular division into smaller units of greater number, that is all that has happened". (*Towne v. McElligott*, 274 Fed. 960.) After the receipt of such a stock dividend, the stockholder's proportional capital interest in the corporation is precisely the same as it was prior to the receipt of the dividend, but that interest is now evidenced by an additional number of shares. Consequently, in order to determine the actual cost per share of the original stock, it becomes necessary to give consideration to the fact that the stockholder's original holding is now represented by an additional number of shares of the same class and character—and hence to divide

the purchase price by the total number of old and new shares in order to ascertain the cost of each share. The spreading of the purchase price of stock over both that originally purchased and that of like kind received as a dividend thereon, is merely a process which is necessarily required in order to determine the actual and not the fictitious cost of the original stock.

On the other hand, where there is not a mere split-up of shares but on the contrary, the issuance, as a dividend of shares of a totally different class and character from the shares upon which the dividend was declared, and which give to the recipient for the first time an interest in the residual assets of the corporation, the new shares constitute income to the stockholder. After the receipt of the dividend, the stockholder has an additional and different interest in the corporation over and above that already held. In such case the cost per share of the original stock is totally unaffected by the receipt of the additional shares of stock distributed as a dividend thereon and no adjustment of the cost of the original stock can be made in the absence of Congressional authorization.

The original cost of the preferred shares which petitioner purchased is not in dispute. The shares of common stock which petitioner received as dividends thereon were income to petitioner and in no way affected the cost of petitioner's preferred stock. Since Congress has not seen fit to provide for any adjustment of the cost of the preferred stock, it follows that, regardless of whether or not Congress exempted the dividends from taxation when received, the action of

the Commissioner in apportioning the cost of the preferred stock between that stock and the dividend stock was improper.

CONCLUSION.

For the foregoing reasons, the decision of the Circuit Court of Appeals is erroneous and should be reversed.

Dated, San Francisco, California,
April 15, 1936.

Respectfully submitted,
JOHN C. ALTMAN,
Attorney for Petitioner.

WILLARD L. ELLIS,
Of Counsel.

(Appendix Follows.)